P-501, 421/CP-92-41 ORDER REQUIRING REVISED COST STUDIES AND PROPOSED RATES USING STIPULATED COST OF MONEY FIGURE

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

Don Storm	Chair
Tom Burton	Commissioner
Marshall Johnson	Commissioner
Cynthia A. Kitlinski	Commissioner
Dee Knaak	Commissioner

In the Matter of a Petition for Extended Area Service From Cotton to Duluth

ISSUE DATE: November 3, 1993

DOCKET NO. P-501, 421/CP-92-41

ORDER REQUIRING REVISED COST STUDIES AND PROPOSED RATES USING STIPULATED COST OF MONEY FIGURE

PROCEDURAL HISTORY

On January 16, 1992, customers in the Cotton exchange filed a petition with the Commission seeking extended area service between it and the Duluth exchange. Cotton is served by Arrowhead Communications (Arrowhead) and Duluth is served by US West Communications, Inc. (USWC).

On October 21, 1992 the Commission issued its ORDER REQUIRING COST STUDIES AND PROPOSED RATES.

On December 22, 1992, USWC filed its cost study and proposed rates.

On December 23, 1992, Olsen, Thielen, & Co., the accounting firm representing Arrowhead, filed its cost study and proposed rates and filed corrected cost and rate information on January 8, 1993.

On January 25, 1993, USWC filed corrected cost and rate information.

On March 3, 1993, USWC filed revised tariff pages reflecting the change in USWC's intrastate Carrier Common Line Charge (CCLC) as approved in the Commission's Order of February 16, 1993, Docket No. P-421/C-90-1184.

On March 15, 1993, Olsen, Thielen filed further revised cost and rate information reflecting USWC's changes.

On March 22, 1993, the Minnesota Department of Public Service (the Department) filed its report concerning the proposed rates and costs and filed Attachments to its March 22, 1993 report on March 26, 1993.

On April 12, 1993, USWC filed its response to the Department's report.

On May 3, 1993, the Department filed comments regarding USWC's response to the Department's report.

Between May and September, Commission staff sent information requests, and conducted question sessions regarding rate of return issues.

On October 12, 1993, the Commission met to consider this matter, took administrative notice of the fact that the Commission approved a 10.64 overall rate of return (ROR) for USWC in its most recent rate proceeding, and deferred consideration of the matter for one week.

On October 15, 1993, USWC and the Department jointly filed a stipulation between USWC and the Department regarding the EAS cost of money issue.

On October 19, 1993, the Commission met to consider this matter.

FINDINGS AND CONCLUSIONS

The Cost of Money Dispute

In its proposed rates for Cotton, USWC used an 11.50 percent overall cost of capital figure based on a 13.4 percent return on equity (ROE) with a 38/62 capital structure.

In many previous dockets, the Department has opposed the Company's proposal. In the course of these dockets, the Department has offered several alternative cost of capital figures. In this case, the Department recommended a 9.29 percent overall cost of money figure based on a 10.5 percent ROE with a 40.6/59.4 capital structure. In the alternative, the Department proposed a 10.146 percent overall cost of money based on an 11.8 percent ROE with a 39/61 capital structure.

The question of what cost of capital should be used in calculating USWC's EAS rates has been before the Commission on a number of occasions and the Commission has adopted the Company's figure. However, in this case a great deal of detailed information has been provided which was not filed in previous cases which requires consideration.

In support of its proposed 11.5 percent cost of capital figure, USWC stated that it updates its cost of money annually, then reviews its capital costs quarterly and changes the annual rate if there is a change of 50 basis points or more. The Company stated that it applied the DCF and CAPM methodologies to three groups of companies comparable to USWC to determine estimated equity capital cost. The Company explained that its debt cost estimate is an average of the cost projected by USWC Treasury Operations for funded debt of 10 and 40 year maturities and that its capital structure is the Company's projected future financing mix: 38 percent debt and 62 percent equity.

In response, the Department proposed using USWC's actual capital structure as presented in USWC's 1992 Incentive Plan sharing filing: 40.6 percent debt and 59.4 percent equity. The Department noted that if the Company expert's latest estimate of the required return on equity derived from a DCF analysis of the Regional Bell Operating companies (11.8 percent) is put into the capital structure used by the Company in its 1993 Incentive Plan compliance filing (39 percent debt; 61 percent equity), the overall cost of capital becomes 10.146 percent. Finally, the Department noted that its cost of equity figure (10.5 percent) is based on 3-5 year future growth estimates which take into account historical data concerning growth rates of dividend per share, book value per share and earnings per share.

At its October 12, 1993 meeting, the Commission heard from the parties and discussed the issue at some length. The Commission took administrative notice of the fact that the Commission approved a 10.64 overall rate of return (ROR) for USWC in its most recent rate proceeding, the Department of Defense rate reduction case.[1] Finally, the Commission postponed further consideration of this matter for one week at the request of USWC to allow the Company to present its financial expert to respond regarding the Company's cost of money recommendation.

The Parties' Stipulation

On October 15, 1993, USWC and the Department presented a Stipulation regarding the cost of money issue. In the Stipulation, the parties agreed that in all pending and future EAS cost study filings, USWC could use a 10.64 percent overall rate of return, USWC's last authorized rate of return set by the Commission. Docket No. P-421/CI-86-354. The parties reserved the right to take different positions on the cost of money issue as it pertains to issues other than EAS cost studies. Further, they agreed either party could reopen discussions with the other

[1] In the Matter of a Petition by the U.S. Department of Defense, the General Services Administration, and All Other Federal Executive Agencies of the United States Challenging the Reasonableness of the Rates Charged by Northwestern Bell Telephone Company, P-421/CI-86-354, ORDER ACCEPTING OFFER OF SETTLEMENT (February 11, 1987).

on the cost of money issue if economic factors underlying the cost of money calculation change in the future. If they could not agree to jointly request that the Commission adopt a new cost of money for EAS study purposes, nothing would prevent either party from presenting the Commission with evidence showing the need for a change in the 10.64 percent figure.

Commission Action

A stipulation is an agreement by the participating parties to take a joint position on certain factual and policy issues on which they initially disagreed. In a stipulation, the parties formalize their agreement on certain issues and offer their unanimity as evidence of the reasonableness of their positions. Essentially, a stipulation is an evidentiary item which the Commission must take into consideration in determining an issue. In determining what cost of money it will authorize USWC to use in calculating EAS rates in this docket, therefore, the Commission takes the stipulation into account but must make its own determination of what cost of money figure is appropriate in this case.

Estimating the Company's cost of money during the period when the EAS rates will be in effect is not an exact science. Several different cost of money figures can be arrived at using different but reasonable approaches. In addition to being the figure stipulated to by USWC and the Department in this case, the overall rate of return figure proposed in the current Stipulation (10.64 percent) is a figure that the Commission found reasonable and supported by substantial evidence when it approved the Settlement in Docket No. P-421/CI-86-354.[2] More important, as suggested by the parties' originally proposed figures, the 10.64 figure remains within the range of reasonableness for use in setting EAS rates at this time. Further, acceptance of this proposed figure would end the on-going challenges by the Department to the figure used by USWC in previous EAS dockets, challenges which have consumed much regulatory attention over the preceding months.

In light of the record created in this matter, therefore, the Commission will approve the use of 10.64 percent as USWC's cost of money figure for EAS rates in this matter. To clarify, it is beyond the scope of this proceeding to preapprove use of that new cost of money figure in USWC's future EAS cost study filings. However, approval of the 10.64 figure for this EAS rate-setting proceeding will serve as precedent in such proceedings. Absent the emergence of new developments or countervailing considerations, therefore, it is likely that the considerations

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[2] See February 11, 1987 ORDER in the Department of Defense Complaint, cited in footnote 1, at page 4.

cited in this Order would lead the Commission to approve rates calculated using the 10.64 figure in those future dockets. To further clarify the scope of this Order, adoption of the new cost of money figure for the Cotton EAS rates does not imply that the cost of money figure approved for use in previous dockets was inappropriate. Both figures are within the range of reasonableness and are supported by substantial record evidence in each case where they were approved. EAS rates resulting from the use of either figure meet the ultimate test of being fair and equitable. Minn. Stat. § 237.161, subd. 3 (b) (1992).

ORDER

1. USWC is hereby authorized to use a 10.64 percent overall rate of return in the extended area service (EAS) cost study filing in this matter.

2. Within 10 days of this Order, USWC shall file cost studies and proposed rates reflecting the change adopted in this Order.

3. Within 15 days of the filing of USWC's revised cost studies and proposed rates, the Department shall file comments updating the report and recommendations it filed in this matter March 22, 1993.

4. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Susan Mackenzie
Acting Executive Secretary

(S E A L)